

The Tax Effect of Grant Money in Rehabilitation Tax Credit Projects

By Mark Primoli
Internal Revenue Service

This tax brief offers guidance with respect to the tax treatment of grant proceeds in rehabilitation tax credit projects and discusses whether or not the expenditures made with grant proceeds would be eligible for the 10% or 20% rehabilitation tax credit.

There are various forms of monetary incentives offered by governmental and tax-exempt entities to help defray the cost of rehabilitating many of our nation's historic structures. The recipient of grant money must first consider several factors before determining whether or not to include the proceeds in income. Two primary factors include whether the recipient is a corporate or non-corporate taxpayer and whether the entity receiving the money has dominion and control over the proceeds. The taxpayer must then determine if the expenditures made with grant proceeds should be included in its computation of qualified rehabilitation expenditures.

Unfortunately, our current tax law does not offer specific guidelines with respect to the issue of taxability, nor does it specifically convey rules regarding whether or not expenditures made with these grant proceeds are allowed to be included in one's computation of qualified rehabilitation expenditures. However, between various decisions

rendered by our courts, actions taken through legislation, and opinions offered through various rulings by the Office of Chief Counsel, the Internal Revenue Service can offer some guidance in this area.

Grants Received by Non-Corporate Taxpayers

Section 61(a) of the Internal Revenue Code provides generally that gross income means all income from whatever source derived. In *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955), the United States Supreme Court held that the concept of gross income encompassed accessions to wealth, clearly realized, over which taxpayers have complete dominion.

If a grant is given to a non-corporate taxpayer (individual or partnership) and that taxpayer has dominion and control over the proceeds, the grant will generally be taxable to the recipient. An example of this type of general purpose grant would be one where the taxpayer can use the funds for any purpose, such as operating subsidies or a general improvement grant.

In *Bailey v. Commissioner*, 88 T.C. 1293 (1987), the court held that the recipient of a façade grant lacked complete dominion and control over the façade because the city's urban renewal agency chose the contractors and paid them directly. Accordingly, the cost of the new façade was not included in the recipient's income and was excluded from the property's basis.

One can draw from this ruling that if the taxpayer had dominion and control over the grant proceeds, the amount would be taxable.

On the other hand, if a taxpayer had dominion and control over grant proceeds, but these funds were given to promote the general welfare of the community, the grant proceeds would be tax exempt under the general welfare doctrine. The Internal Revenue Service has consistently held that payments made under legislatively provided social benefit programs for the promotion of general welfare are not included in an individual's gross income. Examples of general welfare grants include flood relief grants and disaster relocation grants. See *Revenue Ruling 76-395* and *TAM 200016019*.

Urban Revitalization Grants used to fund improvements to business property are normally considered taxable income. Federal grants given to business owners who suffered flood damage to help them recover and improve exterior facades and street level interiors of commercial buildings were determined to be taxable. See *TAM 199919020*, *Doc 1999-17630*.

A grant will also generally be included in gross income if the contributor expected or received something in return (quid pro quo). An example of this type of grant would be one where the contributor receives goods, services, or other direct and quantifiable benefit in exchange for the grant.

Grants Received by Corporate Taxpayers

Generally, grant proceeds received by corporations are excludible from gross income. Grant proceeds received by a corporation are considered to be a capital contribution made by a non-shareholder.

Internal Revenue Code Section 118 was enacted in 1954 to codify and to rationalize a line of court decisions. This code section provides, in part, that

capital contributions made by non-shareholders are exempt from income. Internal Revenue Code Section 362 (c) further provides that these contributions will have no basis.

Non-Taxable Grants

As discussed above, the Internal Revenue Service has consistently held that payments made under legislatively provided social benefit programs for the promotion of general welfare are not included in an individual's gross income.

In addition to general welfare grants, *Revenue Ruling 82-195* provides that payments (grants) received by taxpayers under the National Historic Preservation Act, 16 U.S.C. 470, are not included in the taxpayer's gross income. The Act of 1966 was amended by section 202 (b) in 1980 and provides that "effective December 12, 1980, no grant made pursuant to this Act shall be treated as taxable income for purposes of the Internal Revenue Code.

Effect of Grant Proceeds on Basis

Taxable Grants

If a grant is deemed taxable, the taxpayer will have basis and the rehabilitation tax credit can be taken on any qualified rehabilitation expenditures incurred with the grant proceeds.

Non-taxable Grants

If the grant is deemed non-taxable, basis has not been established and the taxpayer will not be eligible to claim the rehabilitation tax credit on the expenditures made with the proceeds.

This position is fully supported in *Bailey v. Commissioner*, 88 T.C. 1293 (1987). In that case, the court ruled that when a

grant recipient incurs no cost attributable to the improvements made to property, the amount of the grant would not be includible in the basis of that property. The only instance where the Internal Revenue Service ruled that a non-taxable grant could also establish basis was in *Revenue Ruling 74-205*. This ruling concluded that replacement housing payments were not only excluded from income, but increased the recipient's basis in the replacement home. It is important to note, however, that this ruling was criticized by the Tax Court in *Henry L. Wolfers*, 69 T.C. 975 (1978).

Consequently, the general rule disallowing inclusion of tax-free grant proceeds in basis is set forth in *Bailey*, while *Revenue Ruling 74-205* is an exception to this general rule.

Internal Revenue Code Section 362 (c) clearly states that non-shareholder contributions of capital to a corporation would not establish basis in property acquired with the money or property contributed by the non-shareholder.

Conclusion

Taxpayers who receive grants must first determine if the proceeds are taxable or non-taxable. If the grant money is taxable, the taxpayer has basis and the rehabilitation tax credit will be allowed on expenditures made with this money.

If the grant money is not taxable, taxpayers will have no basis and the rehabilitation tax credit can not be claimed on the expenditures incurred with these proceeds.

Grants received by corporate taxpayers fall under the auspices of sections 118 and 362 (c) and would be considered tax-exempt contributions of capital by a non-shareholder. Consequently, no

rehabilitation tax credit would be allowed for the expenditures made with these proceeds.

Grants received by non-corporate taxpayers, such as partnerships and individuals, will include the proceeds in income if they have dominion and control over the funds, unless the proceeds are provided as a general welfare grant or a National Historic Preservation Act grant.

Resources

Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955)

Bailey v. Commissioner, 88 T.C. 1293 (1987).

Henry L. Wolfers, 69 T.C. 975 (1978).

Graff v. Commissioner, 673 Fed 2nd 784, 5th Circuit 1982

Internal Revenue Code Sections 118 and 362(c)

Revenue Ruling 74-205

Revenue Ruling 82-195

Revenue Ruling 76-395.

Revenue Ruling 76-75

Revenue Ruling 98-19

TAM 199919020, Doc 1999-17630

TAM 200016019

Article: "The Taxability of Capital Subsidies and Other Targeted Incentives", by Kimberly S. Blanchard, Tory Haythe, New York, November 5, 1999.

Tax Effect of Grant Proceeds on the Rehabilitation Tax Credit

